EXECUTIVE SECRETARIAT

Routing Slip

TO:		ACTION	INFO	DATE	INITIAL
1	DCI				
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9	Chm/NIC				
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11	IG				
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13	D/EEO				
14	D/Pers				
15	D/OEA				
16	C/PAD/OEA				
17	SA/IA				
18	AO/DCI				
19	C/IPD/OIS				
20	NIO/ECON		✓		
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	SUSPENSE		Date		

Remarks:

Executive Secretary

3/1/83

Date

3637 (10-81)

ILLEGIB

THE WHITE HOUSE
WASHINGTON

CABINET AFFAIRS STAFFING MEMORANDUM

DDI- 1656/83

DATE: 3-1-83 NUMBER: 118530CA DUE BY: _____

SUBJECT: Cabinet Council on Commerce and Trade - Wednesday, March 2, 1983
8:45 a.m. Roosevelt Room

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☑
Attorney General	☑	☐
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☐	☑
Transportation	☑	☐
Energy	☑	☐
Education	☐	☑
Counsellor	☑	☐
OMB	☐	☑
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
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	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Clark	☐	☑
Darman *(For WH Staffing)*	☑	☐
Harper	☑	☐
Jenkins	☐	☑
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CCCT/Gunn	☑	☐
CCEA/Porter	☐	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/Boggs	☐	☐

REMARKS: The Cabinet Council on Commerce and Trade will meet Wednesday, March 2, 1983 at 8:45 a.m. in the Roosevelt Room. Agenda and papers are attached.

Agenda: DISC Alternatives CM # 282 (three papers attached)

Japanese Trade Issues CM # 269 (no papers)

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☑ Becky Norton Dunlop
Director, Office of
Cabinet Affairs
456-2800

THE WHITE HOUSE

WASHINGTON

CABINET COUNCIL ON COMMERCE AND TRADE

March 2, 1983

8:45 a.m.

Roosevelt Room

AGENDA

1. DISC Alternatives (CM#282)
2. Japan Trade Issues (CM#269)

THE WHITE HOUSE

WASHINGTON

March 1, 1983

MEMORANDUM FOR MEMBERS OF THE CABINET COUNCIL ON COMMERCE AND TRADE

FROM: WENDELL GUNN
Executive Secretary

SUBJECT: Agenda for Meeting of March 2, 1983
8:45 am, Roosevelt Room

On February 16, a proposal for replacing the DISC was presented to the Cabinet Council on Commerce and Trade. Among other things the proposal requires that exporting companies conduct a portion of their export activities offshore. The CCCT directed the task force to discuss these provisions with representatives of the business community and report back on March 2.

Attached is an options paper prepared by USTR, with the cooperation of Treasury and Commerce, for your consideration.

The second item on the agenda is a report by USTR on Ambassador Brock's recent visit to Japan. No paper will be circulated on this subject.

A DISC ALTERNATIVE -- ISSUES FOR CCCT DECISION

ISSUES

Consultations with the private sector and Congress, undertaken at the direction of the CCCT at its February 16 meeting, have revealed widespread support for the basic principles included in the Treasury proposal developed in conjunction with USTR and Commerce for a DISC replacement (see attachment). However, considerable concern has been expressed about:

(1) the extent to which companies will have to engage in economic activities outside the United States to meet the foreign presence requirements of the Treasury proposal; and

(2) the fact that the foreign presence requirements of the proposal may make it impossible for small companies to take advantage of the tax benefit.

The CCCT must decide what to do to allay these concerns.

THE PROPOSAL

Under the GATT, the United States would not convey an illegal export subsidy if it exempts from tax sales income which is related to economic activity occurring outside the United States and an arm's length pricing rule is enforced. To conform with this GATT standard, the Treasury proposal replaces the DISC with a foreign corporation through which export sales would be made. The income from such export sales (called Foreign Trading Income or FTI) would be allocated between the foreign sales corporation and its related U.S. supplier using the arm's length procedures

prescribed in Section 482 of the IRS Code* or using one of two safe-harbor rules designed to approximate 482. The safe-harbor allocation would be equal to the greater of:

(1) 17 percent of the FTI; or

(2) 1.35 percent of the foreign corporations gross sales, up to 34 percent of the FTI.

To qualify for either safe-harbor allocation, the foreign corporation would be required to undertake certain economic activities outside the United States. Finally, the income allocated to the foreign corporation would be distributed to the parent on a tax free basis. The current Treasury proposal has less substance than first contemplated. It is not entirely clear that the current proposal is defensible in GATT. However, the current proposal will still allow for a credible GATT defense which will make reference to U.S. tax law and practices.

FIRST ISSUE: FOREIGN PRESENCE REQUIREMENTS

The private sector believes that too much activity must be undertaken outside the United States to qualify for the safe-harbor allocation. Under Treasury's proposal, the foreign corporation to which a safe-harbor allocation is made must:

(1) maintain an office outside the United States

(2) maintain books and records in that office;

(3) have at least one resident director in the foreign office; and

* To maintain revenue neutrality, a cap equal to 34 percent of FTC would be imposed in circumstances where the 482 procedures are used.

(4) hold an agency agreement or distribution license with respect to the product.

In addition, the Treasury proposal requires that more than 50 percent of the total expenses associated with the following activities must be incurred outside the United States by the foreign corporation or for it on a contract basis:

(5) soliciting orders from and negotiating contracts with customers;

(6) processing customer orders; and

(7) billing customers and receiving payment.

If an exporter performs other significant activities outside the United States, the proposal states that consideration would be given to substituting those activities for the items listed above.

Large and some medium-sized companies have no difficulty meeting the first four requirements. (The needs of small companies will be addressed in a later section of this paper.) However, the business community is reluctant to agree to the "additional" three foreign presence requirements (items 5, 6, and 7) for fear that they would markedly reduce the incentive for using the DISC replacement for some companies. The business community would find the proposal more palatable if the "additional" three activities could be performed for the foreign corporation in the United States or if the requirement that 50 percent of these activities be undertaken off-shore be reduced to a lower threshold.

Thus, while the additional foreign presence requirement gives us a very strong defense in the GATT, it may render the proposal unacceptable to the business community, thereby making its acceptance by Congress unlikely. This leaves the CCCT with two options:

(1) further compromise the GATT legality of the proposal by reducing the additional foreign presence requirements; or

(2) allow for negotiating room on the issue by requiring that "some" of these activities be undertaken overseas, clarifying what constitutes "some" later after more lengthy consultations with the private sector and Congress.

Option 1: Reduce the Additional Foreign Presence Requirement

This can be done by reducing the requirement that 50 percent of the total expenses of certain activities be undertaken overseas to 35 percent of only the total direct costs of these activities and expanding the list of activities to include ministerial activities, such as disbursing dividends, legal fees, officers' salaries, and directors' salaries, and paying export-related advertising expenses, and holding Board of Directors and Shareholders meetings.

Pros

1. Will probably make the proposal acceptable to big business, thereby ensuring its support when the proposal is acted upon by Congress.

2. Increases the "incentive" associated with the proposal for exporters.

3. Is probably defensible in GATT, although less so than the Treasury proposal.

Cons

1. Increases the possibility that the DISC alternative will be challenged successfully by the EC or by other GATT contracting parties.

2. A sound defense of this proposal by reference to U.S. tax is not possible. Consequently, a GATT defense of this proposal could not refer to U.S. tax law or practice.

3. It may be bad tactics to concede on a major point before the proposal is under consideration by Congress.

Option 2: Allow for Negotiating Room

This can be easily accomplished by requiring that only "some" of the additional activities be undertaken "in whole or in part" overseas, rather than 50 percent as is in the Treasury proposal. This language would be used in the proposal presented to the GATT Council on March 9. If asked about what is meant by these terms, the U.S. representative to the GATT Council can state that they are technical matters that will be clarified in the legislation or by regulation. In the meantime, we will work closely with the business community and Congress in an effort to find a definition for these terms which is acceptable.

Pros

1. Gives us time to resolve the issue of additional foreign economic presence, and still allows us to meet the March 9 GATT deadline for our proposal.

2. May be tactically more advisable to leave the issue open for resolution as the proposal moves through Congress.

Cons

1. Puts off a critical issue that must be eventually decided.

SECOND ISSUE: SMALL BUSINESS PROVISIONS

Treasury, USTR and Commerce recognize that a small business exception must be included in the proposal. The CCCT has three options for addressing this problem:

1. allowing small businesses to retain their DISC's and impose a deductible interest charge at the government borrowing rate on the deferred taxes;

2. allow for joint participation in foreign sales corporation; or

3. allow small businesses to operate foreign sales corporations in the United States but deem them foreign under United States tax law and require less off-shore economic activity of these foreign corporations.

4. cash flow benefits exceed those of current DISCs.

Option 1: Interest Rate Alternative

Under this alternative, exporters with annual export sales of $10 million or less would be allowed to continue to operate their DISC's. An annual deductible interest charge would be imposed on the value of the tax deferral at the Treasury bill rate. The current pricing rules would remain in effect but the deemed distribution and incremental provisions would be eliminated. The approach is similar to that which has been proposed by Congressman Vander Jagt. In addition, up to 100 percent of the DISC income covered by this alternative could be deferred. This would be necessary to make the approach attractive in light of the additional cost associated with the interest charge.

Pros:

1. This is the simplest and least administratively burdensome alternative.

2. It is legal under the GATT since it imposes an interest charge on the deferred export income.

3. Would cover 85 percent of the existing DISC's, thereby giving most small and mid-sized companies a break.

Cons

1. Since it is not clear under the GATT what an "appropriate" interest rate is, we have no assurance that the interest rate imposed will not be challenged by the EC.

2. As the amount of deferral accumulates, the interest charge will increase over time. The interest charge on accumulated tax deferrals could exceed the current year tax deferral.

Option 2: Joint Participation

This alternative would allow for the formation of foreign sales corporations on a joint basis. Participation would not be limited by type or size of firm. Non-profit entities such as state development corporations and port authorities could be used as the vehicles for foreign incorporation. The joint participation would extend to both usage and ownership so that participants would receive distributions on a patronage basis.

Pros

1. This proposal is defensible under the GATT. It also would be easier to defend than the other two options because it does not create a special exception for small exporters.

2. It reduces the cost and inconvenience to small and mid-size firms associated with meeting the foreign economic presence requirements under the Treasury proposal.

Cons

1. Small and mid-size firms may be reluctant to use this approach due to competitive concerns over protection of trade secrets, confidential business information, and marketing.

Option 3: Deeming a Domestic Entity as Foreign

A third option would be to allow small businesses to set up corporations in the United States which would be deemed to be foreign corporations under U.S. tax law. The rules with respect to arm's length pricing and provisions for the elimination of the incremental rules and assets test would be the same as those provisions in the Treasury proposal. The major difference between this approach and the Treasury proposal is that the only activities small firms would be required to conduct off-shore would be taking title to goods outside the U.S. and/or use of foreign sales agents. The eligibility criteria could be DISC's with annual net income up to $200,000.

Pros

1. This proposal is simple, predictable, and less costly than the other two options.

2. The deviation from the foreign economic presence requirement can be defended in the GATT as being equivalent to the tax treatment of foreign branch operations under European territorial tax systems.

3. Is likely to be a popular alternative with members of Congress who are concerned about small exporters.

4. This proposal would cover 57 percent of the existing DISC's and would account for only 5.3 percent of export receipts.

Cons

1. This proposal will likely invite a successful challenge by the Europeans since it does involve a deviation from the foreign economic activities standard. It therefore may mean they would have to pay the Europeans compensation.

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Small Business DISC Proposal

The majority of DISC benefits, whether measured by gross receipts, net income, or tax-deferred income, are earned by large exporters. Most DISCs, however, are small exporters. In 1980, for example, nearly 80 percent of DISC tax returns were filed by corporate majority shareholders with assets of less than $50 million. These returns accounted for a relatively small proportion of DISC benefits, 15 percent of gross receipts, 15 percent of net income, and 17 percent of tax-deferred income. Measured in another way, DISCs with gross receipts of less than $10 million represented 85 percent of DISC tax returns, but only 9 percent of gross receipts, 12 percent of net income, and 13 percent of tax deferred income. DISCs with net income of less than $1.0 million made up 78 percent of the tax returns, but only 15 percent of gross receipts, 12 percent of net income, and 14 percent of tax-deferred income.

The dual requirements of foreign incorporation and foreign business activity may make it difficult for small exporters to take advantage of the alternative DISC proposal. To insure that small exporters continue to benefit from an export tax incentive, two options are available:

1. Use the foreign sales corporation proposal available to all exporters, but on a joint basis. Two or more small exporters would be permitted to form and operate a foreign sales corporation on a joint basis. The foreign corporation would be required to perform the same activities, and the same proportion of its activities outside the United States, as one owned and operated by a large exporter. As a variant to this, the small exporter could be permitted to satisfy the foreign activities requirement on a contract basis. That is, the small exporter could contract with another party to perform the required activities outside the United States on behalf of the foreign corporation. For this option, any DISC and related DISC with combined export sales of less than $10 million annually would qualify as a small exporter.

2. Continue the DISC mechanism, but impose an interest charge on the value of the tax deferral. The current pricing rules for determining DISC income would remain unchanged. To increase the pool of DISC income eligible for deferral, the deemed distribution and incremental provisions would be eliminated. Thus, all of a DISC's income would be eligible for tax deferral. The DISC's shareholder would pay a tax deductible, annual interest charge at the Treasury-bill rate on the value of the deferred tax. All DISCs and related DISCs with combined export sales of less than $10 million would be eligible for this option.

In connection with allowing the deferral on all the DISC's income, the use of the T-bill rate (rather than "prime plus") would provide small exporters with the same benefits as under present law. The T-bill rate also may be defensible as an "appropriate" interest charge under the Subsidies Code. The Code defines an export subsidy as the granting of export credits by a government at rates below those which the goverment actually pays for the funds. Presumably, then, export credits at or above the cost of money to the government are not considered export subsidies for GATT purposes. It could be argued that this principle can be extended to interest charges on deferred taxes as well.

However, other GATT members might argue that a higher interest charge should be imposed on a deferred tax liability. The November 1976 GATT Panel Report on DISC suggests that to be GATT-legal, a DISC deferral of income tax must bear the interest rate which would normally be levied on late or delinquent taxes. The Panel report notes that a deferral, merely because it is granted for an indeterminate period, is not necessarily an exemption which would constitute an illegal subsidy under Article XVI:4. But because the DISC "deferral did not attract the interest component of the tax normally levied for late or deferred payment [of taxes]," the Panel Report concluded that DISC constitutes a prohibited partial exemption.

This reference in the Panel Report's conclusion to interest charges on late or deferred payment appears to reflect a Panel question to the U.S. representative who argued the DISC case. The U.S. representative contended that DISC deferral was consistent with the fact that no tax system ensured collection of taxes as income accrued. The Panel then quoted the U.S. representative as conceding that in the U.S. "failure to pay taxes when due would in general carry a tax penalty which does bear a conceptual relation to an interest rate because it is measured on the time of delay."

Thus, the GATT Panel Report on DISC suggests that the reference point in judging DISC deferral a subsidy is the failure to charge the interest rate which would be charged on delinquent taxes. Nevertheless, at the risk of admitting that deferral really differs from delinquency, one might argue that in delinquency cases, the interest charged reflects on element of penalty which is not present, and need not be charged, in the case of deferral.